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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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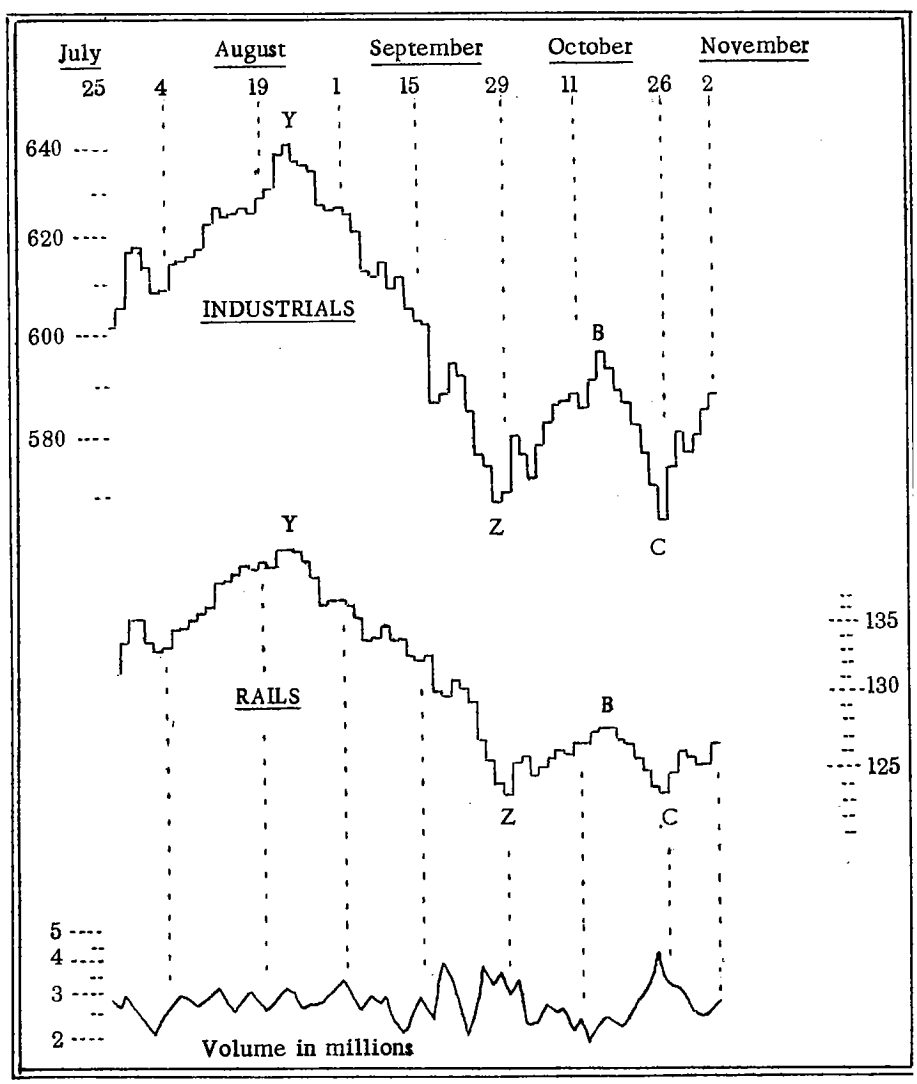
PRICE MOVEMENTS In the last Letter I drew attention to the lack of confirmation by Rails on the decline from B to C (see chart). The Letter went on to say: "Reversals have often been signalled by the refusal of one Average to confirm the penetration of the other." Since C both Averages have rallied, and as of November 2 minor upward zig-zags were formed in both indicators.

If the B points (Industrials 596.48, Rails 127.42) are jointly bettered (particularly on increasing volume) the secondary trend will be pointing up for the first time since June. In this case the odds favor a normal 1/3 to 2/3 correction of the ground lost from T (Industrials 656.42) to Z (Industrials 566.05). A persistent refusal of one or both Averages to better the B points could be an important hint of danger.

Since Rails would not confirm the Industrial weakness at C, we would ordinarily expect Rails to be the leader on the next rally. So far, the Rail action has not been particularly impressive. Continued sluggishness in the Rail Average could be a danger signal; another danger signal might be diminishing volume on an extension of the rally since C. The only important downside points are at C for Industrials (566.05) and Z for Rails (123.37). A violation of those two lows would signify that the third leg of the bear market was extending itself (it would also be a reconfirmation of the primary bear trend.



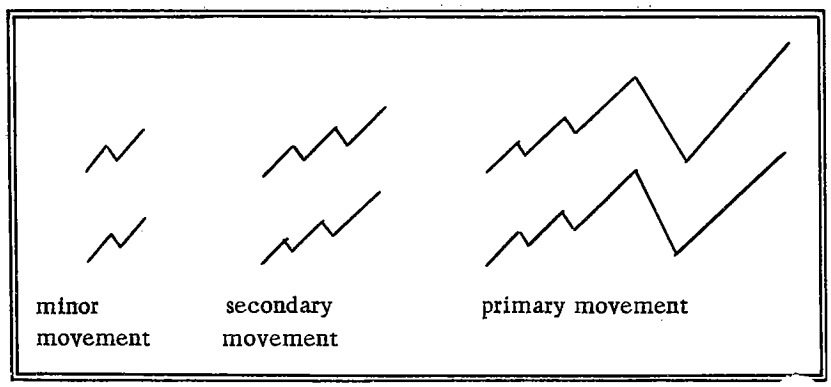
The rally from C has been accompanied by notably poor "breadth" (see later in Letter) as well as an unfavorable ratio of new highs to new lows.

THE MARKET A good many subscribers are asking me whether this is not the time to buy back stocks. They point to the fact that many issues such as Chrysler, Bucyrus-Erie, J.I. Case, Merritt-Chapman, Royal McBee, Arnold Constable, Scovill Mfg. and United Fruit are at or below their lows of the last ten to twenty-five years (Reading Co. has broken its 1932 low, Pennsylvania R.R. is at its 1932 low). Can these

stocks go any lower, one wonders?

We have reached a very interesting juncture, and I believe it is time to call a spade a spade. The few analysts and investment services who were correct enough to be bearish anytime between August, 1959, and March, 1960 (the bear signal) now feel that they are "off the hook". Clients who sold portfolios on the advice of the aforementioned advisers are now happy, and the advisers themselves feel that they have been proven correct. Most of the stocks that were sold can now be repurchased at considerably lower prices. SO -- why push one's luck? Why not tell clients to buy back a few stocks such as aircrafts and oils and "if the market rallies", reason the former bearish advisers, "we'll be double heroes". The real point is that from the standpoint of tactics the bears are breathing easy, and they do not want to get caught on the wrong side.

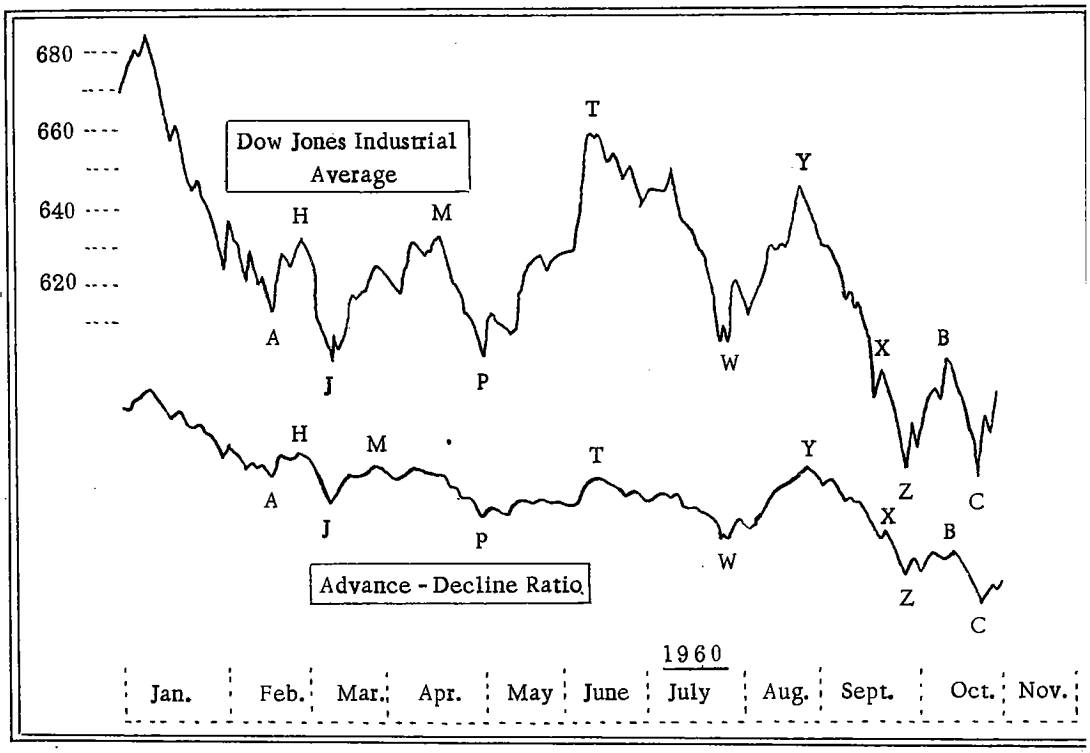
I don't see it that way. Subscribers were mailed a Special Study of Dow's 50% Principle, the implications of an eventual violation of the 548 level were discussed. I also said that if Industrials persistently refuse to violate 548 "I will be the first to judge the movement in the light of the 50% Principle." Personally, I would rather err on the side of safety. If I miss a big upward swing it is unfortunate, but there will be other swings to come. If I put subscribers into a rally in a bear market it may cost them many years of hard-earned capital.



I do not know whether Pennsylvania R.R. is a buy or a bankruptcy at this point. But I do know that I am not ready to buy it myself. Dow's Theory states that the primary trend is taken to remain in force until reversed by a definite indication in the Averages. Rhea felt that this principle should be adhered to during the first and second phases of a bear market and that buying was not justified until the third or final bear market phase was well underway.

I have yet to see evidence suggesting that this bear market is in anything but its second phase. There is no real "scare talk", volume indications suggest that the public has held on to most of its stocks, there is none of the "hopeless" psychology associated with a typical bear market bottom. In fact, judging from recent articles which appeared in Time Magazine and Business Week the consensus is that the "song of the Soaring Sixties" has now changed to "the ode to a mild let-down into mid-1961 followed by an impressive recovery".

Almost all bear market swings but the final one end on high volume. The last primary bear leg usually ends on extremely low volume, and this dullness implies an absence of overhanging liquidation. When both Averages rally for a few days, back off, and then better their preceding little peaks (an upward zig-zag) it is safe to conclude that the minor trend (see small chart) has turned up. When two or more of such upward zig-zags take place, the implications are that the secondary trend has turned up. When, following the third phase of a bear market, an advance reaches secondary proportions, and this advance is then fully corrected by a decline of a few weeks or more, Dow Theorists are all attention. For if the next rise succeeds in taking both Averages over their preceding highs a bull signal will have been given (see chart). This is the confirmation of a primary turn in the tide.



"BREADTH" The advance-decline ratio (A-D ratio) provides a picture of the general market; it is the ratio of the total daily advances and total daily declines on the New York Stock Exchange. I have discussed the A-D ratio on many previous occasions (Letters 90, 93, 101, 105), and this seems to be as good a time as any to review the A-D ratio again.

The A-D ratio is constructed as follows; total daily advances are subtracted from total daily declines (or vice versa if there were more declines than advances), and the resultant amount is divided by the total number of issues traded for that day. This figure is then added (if advances exceeded declines) or subtracted (if declines exceeded advances) to the previous day's figure. This process gives us a continuing advance-decline line or "breadth" indicator. The ratio may be started with any figure. Here is a ficticious example: January 1 shows the ratio to have stood at 50.07. On the next day (January 2) there was a total of 1200 issues traded; of these 350 advanced, 650 declined (200 remained unchanged). We subtract 350 from 650, which leaves 300. Then we divide 300 by 1200 which gives us .25. Since more issues declined than advanced, the .25 figure is subtracted from the January 1 figure, which gives us a January 2 reading of 49.82.

When the D-J Industrials and the A-D ratio confirm each other through respective points the move usually has further to go. Whenever the two indicators diverge the market should be watched carefully. Many important reversals have started in an area where Industrials and the A-D ratio diverged, followed by a confirmation by one or the other indicator in the new direction.

The accompanying chart shows the movements of the D-J Industrial Average superimposed upon the A-D ratio (January to November, 1960). On January 19, 1960, the A-D ratio broke under its September, 1959, low (not shown), which implied that the market was acting considerably poorer than the Industrial Average. As a matter of fact, readers may remember that the A-D ratio "topped" in March, 1959, and this was one of the factors which turned this writer bearish (Letter 90).

On the zig-zag A-H-J (see chart) the D-J Averages gave a primary bear signal, and the A-D ratio broke into new low territory. A rally ensued, and at M the Industrials stopped just short of the preceding rally top (H). On the same rally, however, the A-D ratio advanced begrudgingly, then halted considerably short of H. The decline to P saw the A-D ratio break to another new low, although here Industrials refused to confirm. This allowed for the Industrials surge above M to T. But at T the A-D ratio refused to confirm Industrials by bettering M (the ratio again flattened out from P to T).

In view of the persistent refusal of the A-D ratio to confirm the Industrials, the situation appeared highly dangerous. On the decline to W the A-D ratio sank to a low, but Industrials held at the "600 line" for the third time. Then on the rally to Y the A-D ratio finally bettered a preceding peak, but this time it was the Industrials that would not confirm (by bettering T). At Y, however, "breadth" showed the first hint of strength, and the burden of proof fell to the market.

In September (on the Y-Z decline) Industrials violated the 599.10 level. This penetration was confirmed by a new low (Z) on the A-D ratio. Since mid-September the A-D ratio seems to have lost its "lifting power". Note that at B Industrials bettered the little X peak, while the A-D ratio would not confirm. Following B both Industrials and the A-D ratio broke to new lows. On the latest rally from C, Industrials wiped out most of their B-Z losses, but the A-D ratio refused even to approach its previous low at Z. As long as the A-D ratio continues to outperform the Industrial Average on the downside, the situation suggests technical weakness. Moreover, the last confirmed direction of the two indicators was down. Until a marked divergence appears it is well to give precedence to the last confirmed direction of the Industrials and the A-D ratio.

MUSINGS My market "genie" whispered a strange and contrary story in my ear. He said, "suppose the recent rally was discounting Nixon's election to office. And having discounted that which is favorable to business, supposing Nixon is elected. Might not the market break soon after the "good news" (good news at least for the moneyed interests) is out?" I brushed the genie away. "Talk sense," I growled.

GOLD By a Presidential proclamation (January 31, 1934) an ounce of gold was ruled to be worth $35.00 (the previous price was $20.67). Although U.S. citizens may not hold gold in this country, our Government has continued its policy of selling (or buying) gold to foreigners at the price of $35.00 per ounce.

If an Englishman owns one hundred ounces of gold (now worth $3,500.00) he can buy a Buick in the American market. But if, in the course of time, foreign cars become relatively cheaper or better than comparable U.S. models, it would be said that U.S. cars are overvalued in world markets (and, of course, Mr. Englishman would not buy one).

This over-pricing of U.S. goods together with huge U.S. Government spending abroad creates an imbalance of payments. Gold leaves these shores, and foreign dollar balances (each a call on our gold) build up. Exactly this situation has existed for the last ten years. If the U.S. Government decides that Buicks and all other American goods are overpriced in world markets then one possible course is a devaluation of the dollar. To make it simpler, suppose that the Government decides that it will raise the price of gold to $70.00 per ounce. By doubling the price of gold they have halved the value of the dollar in international markets.

Now what happens? Mr. Englishman discovers that instead of paying 100 ounces of gold for a Buick he can purchase a Buick for 50 ounces of gold. Mr. Englishman buys a Buick, and dollars and gold start flowing back to Uncle Sam.

Of course there is an argument against devaluation -- and a good one. If, after devaluation, the U.S. starts sopping up too much of the world's supply of gold and dollars, then the other countries may decide to devalue their own currencies. This would mean that we were back where we started (except for Russia, who would come out way ahead because of her large gold holdings).

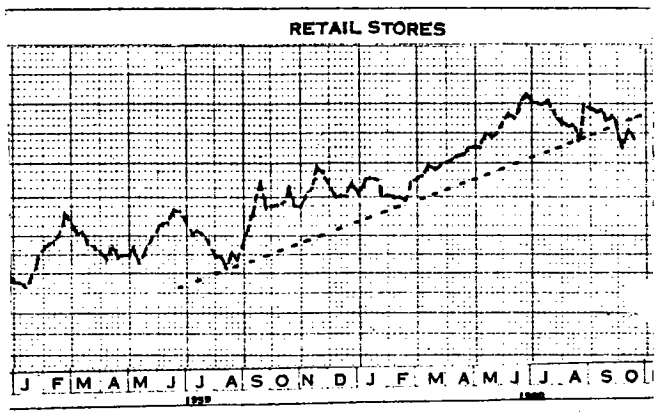
A few more points: The U.S. now holds 18.5 billion dollars worth of gold. By law 25% of total U.S. deposits and currency must be backed by gold. Under present conditions, this means that 11.6 billion dollars worth of our gold must be kept to back the money supply, while 6.9 billion is available to cover foreign claims. But by mid-1960 foreigners held total claims of 20.7 billion against the U.S. (9.7 billion by foreign central banks, 7.7 billion by foreign firms and individuals). This huge total is a "Sword of Damocles" hanging over the U.S. gold stock.

Up to now the great portion of this foreign claim total has been held in U.S. treasury bills or deposits. But if foreigners suspect that devaluation is in the air, they will attempt to withdraw their balances in gold. There is another rather frightening aspect of the picture. Foreigners now own about 20 billion dollars worth of American stocks. If foreigners sense devaluation, they might dump their stocks in an attempt to get out of the U.S. market and into gold or their own currencies. This would result in a wide-open market panic.

In the past, nature has provided a way of periodically "squeezing the water out of the dollar and the economy". This method is known as deflation and depression. The declining stock and commodity markets suggest (so far) that general deflation is the course that the country will take. But rising prices for gold shares suggest that there are those who believe that deflation will not be tolerated, and that the battle will be fought by devaluing the dollar. There are hedges against both contingencies, and they are (1) shorts or "puts" on common stocks, (2) purchase of gold shares. I have suggested a bit of both.

STOCKS One of the economic indicators which has held better than most is retail sales. In view of this it is interesting to see the group relative strength chart of retail stores break an 18 month trend line. This means that there has been distribution in retail stocks; it also suggests that this group could perform worse than the market over the foreseeable future.

(Written - Thursday, November 3rd 2 P.M.)



Charts courtesy of Traders Research Inc.,
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